

Message Text

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AMEMBASSY JAKARTA

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C O N F I D E N T I A L SECTION 1 OF 3 HONG KONG 8001

PASS TREASURY FOR COOPER, BUSHNELL & LEE, & FEDERAL RESERVE
BANK

EMO. 11652: GDS

TAGS: EFIN, MY, CH, KS, TW, RP, ID, SN

SUBJECT: THE ECONOMIC OUTLOOK OF THE EAST ASIAN LDCS AT MID-YEAR

1. INTRODUCTION AND SUMMARY

THIS MESSAGE IS CONCERNED WITH HOW THE BALANCE-OF-
PAYMENTS IN THE DEVELOPING COUNTRIES OF EAST ASIA (OTHER
THAN INDO-CHINA, THAILAND AND BURMA) HAVE BEEN AFFECTED
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BY THE WORLD RECESSION THAT BEGAN IN 1974, AND, BY THE

POLICIES THAT GOVERNMENTS HAVE UNDERTAKEN TO COPE WITH
IT. THE PRINCIPAL CONCLUSIONS ARE:

A) ALL COUNTRIES HAVE IN VARYING DEGREES
ACCEPTED THE FACT THAT GROWTH WOULD HAVE TO
BE SLOWED TO FIGHT INFLATION AND GROWING
BALANCE-OF-PAYMENTS DEFICITS,

B) ALL COUNTRIES (EXCEPT THE PRC) HAVE RELIED
PRINCIPALLY ON MONETARY AND FISCAL MEASURES TO
TACKLE INFLATION AND THE CURRENT ACCOUNT DEFICIT,

C) THE EFFORT OF KOREA AND THE PHILIPPINES
TO STIMULATE GROWTH IN THE FACE OF DEPRESSED
WORLD MARKETS HAS REQUIRED VERY HEAVY FOREIGN
BORROWING,

D) THE CURRENT ACCOUNT DEFICITS OF HONG KONG,
TAIWAN AND THE PRC HAVE ALREADY BEGAN TO IMPROVE
AND THE OTHERS, EXCEPT KOREA, HAVE THE EXTERNAL
FINANCIAL RESOURCES TO CARRY A HIGHER DEFICIT
FOR ANOTHER YEAR,

E) ALL COUNTRY POLICIES ASSUME A SIGNIFICANT
REVIVAL OF THE OECD ECONOMIES IN 1976; IF THAT
DOES NOT OCCUR, THE PRESSURE TO IMPOSE QUANTI-
TATIVE IMPORT CONTROLS AND TO UNDERTAKE
COMPETITIVE DEVALUATIONS WILL BECOME MUCH
GREATER.

2. DEPENDENCE ON INTERNATIONAL TRADE. FOR THE AREA
AS A WHOLE, EXPORTS FORM SUCH A LARGE PERCENTAGE OF
NATIONAL PRODUCTION THAT THEY ARE THE LEADING SECTOR
OF THE ECONOMY AND THEIR GROWTH IS CLOSELY RELATED
TO GROWTH IN GENERAL. THE COMMODITY PRODUCERS HAVE
ALWAYS SPECIALIZED IN PRODUCTION FOR EXPORT. IN THE
PAST TWO DECADES, THE EXPORTERS OF MANUFACTURES -
KOREA, TAIWAN, HONG KONG, AND SINGAPORE HAVE MOVED
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IN THE SAME DIRECTION, TO THE POINT WHERE THE BULK
OF MOST OF THEIR MANUFACTURING INDUSTRIES, OTHER THAN
FOOD PROCESSING, ARE WORKING FOR FOREIGN MARKETS.
IN THE EXTREME CASE, HONG KONG, EVEN THE DOMESTIC
CONSUMERS MARKET FOR TEXTILE PRODUCTS IS PARTIALLY
SUPPLIED FROM ABROAD. THE EXCEPTION IS THE PRC WHERE
ITS CONTINENTAL MASS, HUGE POPULATION AND
RESTRICTIVE TRADE POLICY MAKE EXPORTS A VERY SMALL

PROPORTION OF GNP.

3. GROWTH - THE MAJOR MARKETS FOR THE AREA ARE IN APPROXIMATE ORDER OF IMPORTANCE - JAPAN, THE U.S., AND THE COMMON MARKET. THE MARKED SLOWDOWN, AND THEN DECLINE IN GNP, IN CONSTANT PRICES, HAS NECESSARILY SLOWED GROWTH IN THE EAST ASIAN AREA THROUGH ITS AFFECT ON THEIR EXPORTS BUT WITH A LAG OF 6-12 MONTHS. IN 1975, AREA WIDE GROWTH MAY BE 3-4 PERCENT, GIVEN NOT ONLY THE DIRECT EFFECT OF THE CONTINUING DECLINE IN FOREIGN MARKETS BUT THE POLICY REACTIONS OF GOVERNMENTS TO THEIR RISING CURRENT ACCOUNT DEFICITS.

4. THE TERMS OF TRADE - THE RISE OF FOOD, COMMODITY AND OIL PRICES HAVE HAD VARYING EFFECTS, DEPENDING ON THE COUNTRY SITUATION, BUT THE FOLLOWING GENERALIZATIONS CAN BE MADE OF THE PERIOD TO THE ENND OF 1974:

A) ALL COUNTRIES ARE NET IMPORTERS OF GRAIN, COTTON AND WOOL,

B) ALL HAVE SUFFERED SERIOUSLY FROM THE INCREASE IN OIL PRICES EXCEPT INDONESIA, WHICH HAD PROFITED, AND MALAYSIA WHICH HAS BEEN UNEFFECTED,

C) THE EXPORTERS OF MANUFACTURES HAVE SUFFERED THE MOST ADVERSE SHIFT SINCE THE PRICE OF EVERYTHING THEY BUY HAS RISEN MORE RAPIDLY THAN THE PRICE OF THEIR PRODUCTS.

IN 1975, A GRADUAL IMPROVEMENT IN THE TERMS OF TRADE OF THE EXPORTERS OF MANUFACTURES CAN BE EXPECTED AS GRAIN AND COMMODITY PRICES DECLINE AND OIL STABILIZES. THE TERMS OF TRADE OF THE COMMODITY
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PRODUCERS (INCLUDING INDONESIA), WHICH HAVE BEEN DETERIORATING SINCE MID-1974, SHOULD GO ON FALLING.

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PASS TREASURY FOR COOPER, BUSHNELL # LEE, # FEDERAL RESERVE
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5. FOREIGN PRIVATE INVESTMENT AND CREDIT. BY
WORLDWIDE LDC STANDARDS, THE AREA (EXCEPT THE PRC)
HAS BEEN EXTRAORDINARILY HOSPITABLE TO FOREIGN
PRIVATE INVESTMENT IN THE PAST TEN YEARS. IMPORTANT
INVESTMENTS HAVE BEEN MADE IN MANUFACTURING, PRIMARILY
TEXTILES AND ELECTRONICS, BUT ALSO IN PETROCHEMICALS
AND FERTILIZER. IN A FEW COUNTRIES, ESPECIALLY
INDONESIA, THERE HAVE BEEN MAJOR INVESTMENTS IN
MINERALS, OIL EXPLORATION AND PRODUCTION AND TIMBER.
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6. FINALLY, THERE HAS BEEN A MAJOR INWARD MOVEMENT
OF BANKS, AND RELATED FINANCIAL INSTITUTIONS, PRIMARILY
AMERICAN, INTO HONG KONG, SINGAPORE AND THE PHILIPPINES
AND, TO A LESSER DEGREE, IN ALL THE OTHER COUNTRIES.
BUT THERE HAVE BEEN CROSS CURRENTS IN THE PAST TWO
YEARS. GIVEN THE RECESION, FOREIGNERS HAVE LESS

MONEY TO INVEST. GOVERNMENTS, HAVING ATTRACTED, IN SOME CASES, THE INVESTMENT THEY HAVE WANTED HAVE RAISED BARRIERS AND REDUCED INCENTIVES. FOREIGN INVESTMENT BY ONE COUNTRY OR ANOTHER HAS ELICITED A HOSTILE POPULAR REACTION IN A FEW COUNTRIES. NEVERTHELESS, NATIONALIZATION, DIRECT OR INDIRECT SEEMS UNLIKELY IN THIS AREA SO THAT IT IS REASONABLE TO ASSUME THAT ONCE THE WORLD ECONOMY REVIVES, THE FLOW OF PRIVATE INVESTMENT PROJECTS WILL RISE ONCE MORE.

7. FOREIGN BANK CREDIT, NOT GUARANTEED BY HOME GOVERNMENTS, HAS BECOME A MAJOR SOURCE OF BALANCE-OF-PAYMENTS FINANCE AND EVEN OF PROJECT FINANCE IN THE CASE OF INDONESIA'S PERTAMINA COMPANY AND BETTER KNOWN PRIVATE COMPANIES (INCLUDING LOCAL BANKS) IN HONG KONG AND OTHER PLACES WHERE EXCHANGE CONTROL IS NOT A PROBLEM. BUT, IN GENERAL, THE BANKS HAVE RELIED ON LOCAL GOVERNMENT GUARANTEES FOR MEDIUM-TERM CREDIT. BANK CREDIT, BOTH SHORT AND MEDIUM-TERM, HAS PLAYED A MAJOR ROLE IN THE FINANCING THE WIDENING BALANCE-OF-PAYMENTS DEFICIT IN 1974 AND THIS YEAR. THE PREFERRED POLICY HAS BECOME ONE OF TRYING TO CONSERVE EXTERNAL RESERVES TO THE MAXIMUM EXTENT POSSIBLE, USING THEM INDIRECTLY AS COLLATERAL FOR BORROWING ABROAD. ANOTHER TECHNIQUE IS TO PROVIDE INCENTIVES FOR IMPORTERS TO UTILIZE FOREIGN TRADE CREDIT OF ONE KIND OR ANOTHER. EVEN THE PRC HAS RESORTED TO FOREIGN BANK CREDIT ON A MAJOR SCALE, ALTHOUGH MANY OF THE TRANSACTIONS REMAIN UNPUBLICIZED.

8. THE TRADE-OFF BETWEEN GROWTH AND FINANCIAL STABILITY. ALL GOVERNMENTS BEGAN IN 1974 WITH CUSHIONS OF EXCEPTIONALLY HIGH GROWTH, GENERALLY COMFORTABLE EXCHANGE RESERVES AND AN IMPORTANT POTENTIAL FOR CONFIDENTIAL

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ADDITIONAL BORROWING. ALL WERE PREPARED TO FIGHT INFLATION, AND INDIRECTLY THE BALANCE-OF-DEFICIT, AND PAY SOME PRICE IN THE GROWTH. BUT THE RELATIVE PRIORITY ATTACHED TO STABILITY AS COMPARED TO GROWTH RANGED FROM VERY HIGH AS IN THE CASE OF TAIWAN AND HONG KONG TO VERY LOW IN THE CASE OF KOREA AND THE PHILIPPINES WITH THE OTHER COUNTRIES RANGED IN BETWEEN.

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9. THE BALANCE-OF-PAYMENTS OF THE INDUSTRIAL EXPORTERS - KOREA, TAIWAN, HONG KONG AND SINGAPORE.

IN 1974 EXPORTS FOR THE YEAR WERE EXCELLENT BASED ON A SUPERLATIVE FIRST HALF. ALL FACE IN 1975, A DECLINE OF EXPORT RECEIPTS IN CURRENT DOLLARS. BUT THE TRADE BALANCE IN TAIWAN AND HONGKONG IS BEING RESTORED BY A FALL OF IMPORTS WHERE AS IN KOREA THEY CONTINUE TO RISE. THE DIFFERENCE RESULTS FROM KOREA'S EIGHT PERCENT GROWTH RATE IN 1974 AND POLICY GOAL OF SEVEN PERCENT GROWTH THIS YEAR. KOREA IS PAYING THE PRICE OF INFLATION, OVER 20 PERCENT PER ANNUM, AND A VERY SERIOUS INCREASE IN ITS EXTERNAL DEBT, ALREAAY HIGH AT THE BEGINNING OF THIS PERIOD. KOREA HOPED BY ITS DEVALUATION AT THE END OF 1974 TO AVOID THE DILEMMA BUT DID NOT SUCCEED.TAIWAN AND HONG KONG HAVE NO INFLATION IN THE CURRENTLY ACCEPTED SENSE AND NO EXTERNAL FINANCING PROBLEMS BUT THEY WILL HAVE SUFFERED TWO YEARS OF STAGNATION. SINGAPORE'S RECEIPTS, BASED ON THE ENTREPOT TRADE AND TRADE WITH THE FLOURISHING INDONESIA MARKET HELD UP LONGER IN 1974 THAN THE OTHERS. THIS YEAR ITS GROWTH WILL BE SLOWER BUT THE CURRENT ACCOUNT DEFICIT LARGER THAN IN 1974. THERE ARE NO INFLATION AND BALANCE-OF-PAYMENTS FINANCING PROBLEMS.

10. THE BALANCE-OF-PAYMENT OF TWO COMMODITY PRODUCERS- MALAYSIA AND THE PHILIPPINES. THE COMMODITY PRICE BOOM IN 1973/EARLY 1974 PRODUCED RECORD EXPORT EARNINGS IN 1974 WHICH BEGAN TO RECEDE TOWARD THE END OF CONFIDENTIAL

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THE YEAR. THE OUTLOOK FOR 1975 IS FOR A DECLINE IN RECEIPTS BUT WITH IMPORTS CONTINUING TO RISE IN THE PHILIPPINES WHILE LEVELING OFF AND POSSIBLY DECLINING IN MALAYSIA. GROWTH WILL BE LESS THAN FIVE PERCENT IN BOTH WITH THE PRICE RISE IN THE 10-15 PERCENT RANGE IN THE PHILIPPINES AND UNDER 10 PERCENT IN MALAYSIA. THE LATTER WITH HIGH RESERVES AND A LOW EXTERNAL DEBT CAN EASILY FINANCE ITS FIRST TRADE DEFICIT IN SEVEN YEARS. THE PHILIPPINES ALSO HAS SUBSTANTIAL RESERVES, BUT BASED ON A HIGH LEVEL OF BORROWING AT SHORT AND MEDIUM-TERM. THE LARGE CURRENT ACCOUNT DEFICIT IT FACES THIS YEAR CAN BE MANAGED WITHOUT TROUBLE BUT ONLY AT THE COST OF ONCE AGAIN MOVING TWOARD THE HIGH EXTERNAL DEBT SITUATION OF 1969-70 FROM WHICH THE COUNTRY HAD RECOVERED IN THE YEARS 1970-73.

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PASS TREASURY FOR COOPER, BUSHNELL # LEE, # FEDERAL RESERVE
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11. THE BALANCE-OF-PAYEMENTS OF INDONESIA. THE COUNTRY'S
GROSS EXPORT RECEIPTS MORE THAN DOUBLED BECAUSE OF THE
WORLDWIDE INCREASE IN THE COST OF OIL IN 1974. IN
1975 THEY ARE EXPECTED TO DECLINE. THE COMMODITY
EXPORTS-- RUBBER, TIMBER, EXT., HAVE SUFFERED PRICE
DECLINE AND ITS HIGH QUALITY OIL FACES A TEMPORARILY
DECLINING MARKET IN JAPAN, AGGRAVATED BY EXPANDING
EXPORTS OF CHINESE CRUDE OIL. IMPORTS, IN THE MEAN-
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TIME, CONTINUE TO RISE FED BY AN EXPANSIVE BUDEGTARY POLICY AND RISING PRICES (20 PERCENT PLUS PER ANNUM). THE CAPITAL ACCOUNT, HEAVILY IN SURPLUS IN 1974 FROM A LARGE ROGRAM OF CONCESSIONAL ASSISTANCE, MAJOR PRIVATE INVESTMENTS IN RESOURCES AND MANUFACTURING AMD COMMERCIAL LENDING , HAS BEEN HIT HARD BY THE CONSEQUENCES OFPERAMINA'S RECKLESS FINANCIAL POLICY. OVER A BILLION DOLLARS OF SHORT-TERM CLAIMS WILL HAVE TO BE PAID OFF THIS YEAR, NOT ALL OF WHIICH CAN BE REFINANCED BY NEW CREDITS. WHILE STILL IN CONFORT-ABLE CIRCUMSTANCES, INDONESIA HAS RUJOINED THE WOLD OF BALANCE-PAYMENTS CONSTRAINTS.

12. THE BALANCE -OF-PAYMENTS IN THE PRC - IN 1974, THE PRC SUFFERED ITS LARGEST TTRADE AND BALANCE-OF-PAYMENTS DEFICIT TO DATE. ALTHOUGH EXPORTS CONTINUED TO RISE, IMPORTS INCREASED MUCH MORE RAPIDLY. SINCE EXPORTS CONSIST OF FOODSTUFFS, METALS, OIL AND MANUFACTURES, IT IS DIFFUCULT TO TELL WHETHER THERE WAS AN ADVSERSE SHIFT OF THE TERMS OF TRADE IN 1974. THE BEST GUESS WOULD BE THAT THEY EITHER STAYED THE OR IMPROVED , GIVEN THE CHINESE HABIT OF MAINTAINING HIGH PRICES IN THE FACE OF FALLING DEMAND LONGER THAN MOST SELLERS. IN 1975, IT IS CLEAR THAT WITH THE PRICES OF ALL MAJOR EXPORT COMMODITIES DECLINING, THER TERMS OF TRADE HAVE SUFFERED. THE COUNTRY HAS BORROWED HEAVILY AT COMMERCIAL INTERST RATES AND ON SHORT MATURITES TO COVER THIS DEFICIT. RECOGNIZING THIS IS NOLY AN EXPEDIENT, IT HAS MOVED SWIFTLY SINCE THE FALL OF 1974 TO REDUCE IMPORTS, AND PROMOTE EXPORTS, PARTICULARLY OIL TO JAPAN AND, TO SOME EXTENT, MANUFACTURED PRODUCTS EVERYWHERE.

13. CONCLUSION- THE POLICY REACTIONS OF THE EAST ASIAN COUNTRIES HAS BEEN ENCOURAGING. ALMOST ALL HAVE REALIZED THAT INFLATION AND THE PROSPECTS OF A CURRENT ACCOUNT DEFICIT WELL IN EXPCESS OF THE PROBABLE NET INFLOW OF MEDIUM AND LONG-TERM CAPITAL COULD NOT BE TOLERATED VERY LONG. THEY HAVE VERY LARGELY AVOIDED QUANTITATIVE TRADE RESTRICTIONS AND RELIED MAINLY ON CREDIT AND FISCAL MEANSURES TO COOL THEIR ECONOMIES
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AND THE DEMAND FOR IMPORTS. THEY HAVE ACCEPTED SLOWER GROWTH IN THE EXPECTIATION AND HOPETHAT GROWTH IN THE OECD COUNTRIES WOULD PICK UP WITHIN A YEAR OR SO.

14. THE CURRENT ACCOUNT DEFICITS OF TAIWAN, HONG

KONG AND THE PRC ARE ALREADY BEGINNING TO IMPROVE. WHILE THOSE OF THE OTHER COUNTRIES CONTINUE TO DETERIORATE, THEY HAVE THE EXTERNAL FINANCIAL RESOURCES TO COVER THE GAP FOR ANOTHER YEAR WITHOUT SERIOUSLY ENDANGERING THEIR CREDITWORTHINESS. THE EXCEPTIONS ARE KOREA AND TO A LESSER DEGREE THE PHILIPPINES. KOREA HAS STRAINED ITS HIGHLY COMPETITIVE EXPORT INDUSTRIES TO THE LIMIT IN ITS EFFORT TO MAINTAIN A HIGH RATE OF GROWTH FOR POLITICAL REASONS. STARTING THIS PERIOD WITH ONLY MODERATE EXTERNAL RESERVES, IT HAS NOW REACHED THE POINT WHERE IT HAS VERY LITTLE SHORT-TERM BORROWING CAPACITY LEFT AND IT WOULD BE DIFFICULT TO INCREASE MUCH MORE THE ALREADY VERY HIGH LEVEL OF OFFICIAL CAPITAL AND EXPORTER CREDITS. THE CONSEQUENCE IS THAT KOREA IN THE FUTURE WILL HAVE TO GROW SLOWER THAN WOULD OTHERWISE HAVE BEEN POSSIBLE TO RESTORE SOME OF ITS CREDITWORTHINESS.

15. THE PHILIPPINES, ON THE OTHER HAND, HAS NOT FELT THE FULL EFFECTS OF THE RECESSION UNTIL THIS YEAR. IT ARRANGED FOR BALANCE-OF-PAYMENTS CREDITS ON GOOD, IF COMMERCIAL TERMS, WELL BEFORE THE HERSTATT CRISIS. BUT FOR REASONS OF POLITICAL CONSOLIDATION IT GOES ON STIMULATING A GROWTH RATE NOT APPROPRIATE TO ITS PRESENT BALANCE-OF-PAYMENTS OR EXTERNAL DEBT SITUATION IN THE EXPECTATION (AND HOPE) THAT BY 1977, ITS EXPORTS RECEIPTS WILL RISE SUFFICIENTLY TO PAY FOR THE ADDITIONAL DEBT SERVICE. BOTH COUNTRIES APPEAR TO BE ASSUMING IN THE NEXT COUPLE OF YEARS AND EARLY SEVENTIES WORLD BOOM SITUATION THAT IS UNLIKELY TO RE-OCCUR SOON.
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